ClearBridge Investments

Small Cap Growth Strategy

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Key Takeaways

- An invisible foe, COVID-19, has triggered a pandemic, sparked historic volatility and caused a global recession.
- We have held many conversations with portfolio companies centered on continuity, financial resources and modified operating plans and have eliminated or reduced positions with heightened financial risk or operating challenges.
- Our investment process remains focused on thoughtfully financed growth businesses that can endure periods of macro dislocation. Competitive advantages may widen during this extraordinary period of national stress.

Stock Market and Strategy Impact

There are times when words feel insufficient to adequately capture thoughts and the enormity of events. The 9/11 terrorist attacks and aftermath were one such instance. Now we are confronted by an invisible foe, COVID-19, which has triggered a pandemic, heightened fears of personal safety and caused a global recession.

What started as a distant threat to the Asian supply chain has now engulfed humankind as national and local health officials contain and mitigate. The demand destruction of the partial economic shutdown is palpable, sudden, severe and without precedent. These effects would have been enough to undercut financial markets without the added "Black Swan" of a market share battle in the already sharply contracting global energy market.

Few industries (save for some areas of health care and consumer staples) are spared near-to-intermediate term consequences. The aggregate severity depends on the swift implementation of the $2.2 trillion CARES Act, providing relief to stressed consumers and tens of millions of smaller businesses and individuals most affected. Blunting the rapid spike of unemployment through direct payments and extended benefits is critical, as are plans to defer mortgage and rent obligations until conditions stabilize.

The central bank has delivered with several rate slashes and credit market stabilization tactics. Lessons learned from the 2008–09 credit crisis left U.S. financial institutions in better condition after the capital building and stress tests of the past decade. Credit spreads have widened materially, and we anticipate financial institutions will work with debtors as covenants are inevitably breached.

The Strategy has virtually no direct exposure to several of the most affected industries such as casual dining, gaming and discretionary transportation.

The equity market fell precipitously in reaction to the rapidly evolving health crisis as a variety of leveraged investors unwound positions. Volatility (measured by the CBOE Volatility Index, better known as the VIX) spiked to new highs as uncertainty of disease progression and financial impact, combined with credit market anxieties, soared.

Small capitalization stocks materially underperformed larger stocks from the mid-February market peak and by 11 percentage points for the quarter as measured by the Russell 2000 Index versus the S&P 500 Index. This is unsurprising given the "dash for cash." Growth stocks outperformed value stocks across the U.S. stock market spectrum, and in the small cap world the Russell 2000 Growth Index outperformed the Russell 2000 Value Index by 990 basis points.

During the market selldown (February 20 – March 31) and for the first quarter, the Small Cap Growth Strategy outperformed the Russell 2000 Growth Index benchmark by 55 basis points and 216 basis points respectively.

COVID-19 Strategy Actions

ClearBridge Investments invoked its Business Continuity and Operational Risk program mid-March with all systems operating, enabling the Small Cap Growth team and all supporting employees to function remotely. Our investment process remains constant with a philosophical preference for thoughtfully financed growth businesses that can endure periods of macro dislocation. Competitive advantages may widen during this extraordinary period of national stress.

ClearBridge investment professionals have held a series of conversations with portfolio companies centered on continuity, financial resources (balance sheet) and modified operating plans (revenue disruption, expense mitigation, capital spending, responsibilities to employees and communities.) For the next few quarters, the managements of the companies we hold in the portfolio face materially different "facts" compared with when the investments were originally made.

The impact of the epidemic is highly variable, dependent on end market, supply chain and business model:

- Given our bias for recurring revenue businesses and more conservative capital structures, the Strategy has virtually no direct exposure to several of the most affected industries such as casual dining, gaming and discretionary transportation.
- As anticipated, many of the "steady Eddie" businesses have held up well, both from an operating and stock market perspective.
- Other stocks proved less resilient either due to i) financial leverage, ii) valuation compression or iii) likely blunted new business momentum. We believe these companies have the financial resources to await a resumption of growth in the core business.
- Most of the companies in the Strategy have moderate-to-middling disruption risk. A few investments benefit from either accelerated behavioral changes (cloud adoption) or consumer

stocking (staples). And a few companies have significantly higher risk due to end market exposure (i.e., energy, where the Strategy has modest holdings).

- Most companies in the Strategy are "full speed ahead" on product development and innovation spending. Managements continue to see substantial future opportunities while being careful to plan for inevitable shorter-term disruptions.
- A few companies have already raised equity capital, buying longevity "insurance" at the expense of a dilution "premium." We can reasonably expect to see more of this throughout the capital markets in the months ahead.

Portfolio actions during the quarter eliminated or reduced a few positions with heightened financial risk or operating challenges (including MTS Systems in the IT sector, Glaukos in the health care sector, Insperity in the industrials sector ,WisdomTree Investments in the financials sector, and Shutterstock in communication services). In addition, we exited Forescout Technologies in the IT sector ahead of its acquisition by a private equity buyer and Phreesia in the health care sector. We have also initiated new positions in biotechnology firm Amicus Therapeutics and health care services provider Livongo Health and increased our investment in Silk Road Medical as valuations compressed significantly, giving us an opportunity to reposition assets.

Outlook

We anticipate a volatile and bumpy market ahead. While stocks have rebounded somewhat off the March lows due to policy responses, news over the next few months (infections, mortality, unemployment, company revisions, bankruptcies) will be predominantly somber and sobering.

Our hearts and minds are foremost with the victims and selfless health care providers who have rushed to treat the afflicted, frequently without adequate resources. We're also thinking about the U.S. supply chain employees (groceries, warehouses, logistics, etc.) in essential industries, who are keeping America fed and comfortable while distancing policies are in place to limit the illness. All are at elevated risk, despite precautions, and we have admiration and an unspoken debt of obligation once the virus subsides.

COVID-19 is a period and circumstance without precedent and which we will all remember. We can't wait for the COVID-19 anxieties and health care stresses to be in the rearview mirror from either innovative medical breakthroughs or a seasonal decline of the disease.

As always, we appreciate and value your interest in the Small Cap Growth Strategy. Please stay healthy and safe.

Portfolio Highlights

On an absolute basis, the Strategy had losses across nine of the 10 sectors in which it was invested during the first quarter (out of 11 sectors total), with the materials sector delivering gains. The primary detractors from performance were the industrials and health care sectors.

In relative terms, stock selection and sector allocation contributed to performance. Specifically, stock selection in the consumer discretionary, IT, industrials, materials and consumer staples sectors and an overweight to IT aided results. Conversely, stock selection in the health care and financials sectors and an underweight to health care detracted from relative performance.

The leading contributors to absolute returns during the first quarter included DocuSign, BJ's Wholesale Club, Qualys, Inphi and Core-Mark Holding. Positions in National Vision Holdings, Syneos Health, Fox Factory, Cornerstone Ondemand and Heron Therapeutics were the greatest detractors from absolute returns.